REPORT OF THE AUDITOR OF PUBLIC ACCOUNTS
AUDIT EXAMINATION OF THE
<u>KENTUCKY LOTTERY CORPORATION</u>

Fiscal Year Ended June 30, 2000 and 1999

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February 5, 2001

To the People of Kentucky
Honorable Paul E. Patton, Governor
Honorable David L. Williams, President, Kentucky Senate
Honorable Jody Richards, Speaker, Kentucky House of Representatives
Board of Directors, Kentucky Lottery Corporation

As Auditor of Public Accounts, I am pleased to transmit herewith the twelfth full financial and compliance audit of the books and records of the Kentucky Lottery Corporation (Corporation) as required by KRS 154A.130.

The audit was performed by the independent accounting firm of PricewaterhouseCoopers LLP (firm) in accordance with generally accepted government auditing standards. The audit included the balance sheets as of June 30, 2000 and 1999; the related statements of revenues, expenses, and changes in retained earnings and cash flows for the years then ended; notes to the financial statements; and a report on compliance and internal controls, together with comments and recommendations on the Corporation's internal control.

The firm's report on the financial and compliance audit is attached and is summarized as follows:

1) The Corporation's financial statements are presented fairly in all material respects.

2) At June 30, 2000, the Corporation's assets totaled $378,207,000; a decrease of $49,309,000 over June 30, 1999.

   Significant changes in assets from the prior year included:

   - Decrease in total investments (current and long-term) of $46,519,000.

   - Decrease in accounts receivable (net) of $8,857,000.

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3) At June 30, 2000, the Corporation's liabilities and equity totaled $378,207,000; a decrease of $49,309,000 over June 30, 1999.

   Significant changes in liabilities and equity from the prior year included:

   - Decrease in retained earnings of $6,246,000 due to current year net loss.

   - Decrease in total estimated prize liability (current and long-term) of $40,044,000.

4) Significant items concerning the statements of revenue, expenses, and changes in retained earnings for the year ended June 30, 2000, included:

   - Gross profit was $200,183,000; a decrease of $2,270,000 over 1999.

   - Operating expenses decreased $2,330,000 over 1999.

   - Net income before transfer of dividends to the Commonwealth increased $11,618,000 over 1999.

   - Dividends to the Commonwealth were $162,205,000; an increase of $2,616,000 over 1999. The increase included a transfer of $2,875,000 to the affordable Housing Trust Fund from uncollected prize winnings.

   - Net loss was ($6,246,000) and ($15,248,000) for 2000 and 1999, respectively.

   - Retained earnings were $45,753,000; a decrease of $6,246,000 over 1999.

5) Significant items concerning the statement of cash flows for the year ended June 30, 2000, included:

   - Net cash provided by operating activities decreased $14,892,000 over 1999.

   - Net cash used in noncapital financing activities increased $2,616,000 over 1999.

   - Net cash used in capital and related financing activities decreased $1,843,000 over 1999.

   - Net cash provided by investing activities increased $27,400,000 over 1999.

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6) As discussed in Note 4, the Corporation has adopted GASB Statement No. 31, "Accounting and Financial Reporting for Certain Investments and for External Investment Pools," which establishes accounting and reporting guidelines for government investments and investment pools. The adoption of this Statement requires investments to be presented at fair value. In prior years, investments were reported at cost and adjusted for the accretion of interest based upon the purchased yield and maturity date. The Corporation's net income increased from $9,099,000 in 1997 to $27,608,000 in 1998; however, it should be noted that $23,775,000 and $6,370,000 of the increase in 1998 and 1997, respectively was due to adoption of GASB Statement No. 31. In turn, the Corporation's net income decreased from $27,608,000 in 1998 to ($15,248,000) in 1999 from adoption of this same statement as a result of reporting investments at fair value instead of the historical cost method. The difference in the evaluation of the investments for 1999 and 2000 was ($17,482,000) and ($6,246,000), respectively.

7) As discussed in Note 13, the Corporation has approved revisions to the its Rules and Regulations of the "special claim period" for claimants of qualified prizes to exercise an option to receive the lump-sum cash value equivalency of their remaining annuitized prizes. This option allows pre-October 22, 1998 winners to elect a single cash payment of the remaining value of their prize within an 18-month period. This option period covers fiscal years ending June 30, 2000 and June 30, 2001. The Corporation recorded a loss of $4,964,000 on these single cash payments in fiscal year 2000. As of the date of this report, the Corporation will record a loss of $13,655,000 for the fiscal year 2001, with the ultimate financial statement impact of any additional single cash payment elections to be undetermined.

8) The Corporation defines gross revenues as total sales. For the year ended June 30, 2000, these totaled $583,678,000. Dividends paid to the Commonwealth totaled $159,330,000, or 27.3 percent of total sales.

   KRS 154A.130 states the intent of the Legislature regarding dividends paid to the Commonwealth:

   > After the start-up costs are paid, it is the intent of the Legislature that it shall be the goal of the Corporation to transfer each year thirty-five percent (35%) of gross revenues to the general fund . . ..

   The Corporation did not meet this goal since only 27.3 percent of total sales were transferred to the Commonwealth. The goal, based on total sales of $583,678,000, would have been $204,287,300. This is a shortfall of $44,957,300 of the goal.

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9) The Corporation's financial statements will be included in the Commonwealth's Comprehensive Annual Financial Report for the year ended June 30, 2000.

10) The firm tested the Corporation's compliance with certain provisions of laws, regulations, contracts, and grants. While not giving an opinion on the Corporation's overall compliance with such provisions, the firm stated that the results of its tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards.*

11) The firm considered the Corporation's internal control over financial reporting in order to determine auditing procedures for the purpose of expressing an opinion on the financial statements, not to provide assurance on the internal control over financial reporting. The firm noted no material weaknesses involving the internal control over financial reporting.

The Corporation entered into an agreement with the public accounting firm of Crowe, Chizek and Company, LLP, to perform the function of "drawing auditor" for the computer on-line games operated by the Corporation during the year ended June 30, 2000. Quarterly reports on the results of the drawing observations and certifications are made by Crowe, Chizek for the on-line games. In addition, Crowe, Chizek observes and reports on the procedures used to certify the lotto balls used in all games. All reports are available for review in the Office of the Auditor of Public Accounts.

Respectfully submitted,

Edward B. Hatchett, Jr.
Auditor of Public Accounts

Kentucky Lottery Corporation

Report on Audits of Financial Statements

for the years ended June 30, 2000 and 1999

CONTENTS

Report of Independent Accountants

To the Auditor of Public Accounts, Commonwealth of Kentucky and
the Board of Directors, Kentucky Lottery Corporation

In our opinion, the accompanying balance sheets and the related statements of revenue, expenses and changes in retained earnings, and cash flows present fairly, in all material respects, the financial position of the Kentucky Lottery Corporation (the Corporation), a component unit of the Commonwealth of Kentucky, at June 30, 2000 and 1999, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States. These financial statements are the responsibility of the Corporation's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States and standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. These standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for the opinion expressed above.

In accordance with *Government Auditing Standards*, we have also issued our report dated August 2, 2000 on our consideration of the Corporation's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts and grants.

PricewaterhouseCoopers LLP

August 2, 2000, except as to
information included in Note 13
for which the date is November 29, 2000

Kentucky Lottery Corporation
Balance Sheets

June 30, 2000 and 1999
(dollars in thousands)

ASSETS	2000	1999
Current assets:		
Cash and equivalents	$ 29,793	$ 22,711
Investments at fair value, current portion	34,047	36,115
Accounts receivable, net	19,477	28,334
Ticket inventories	385	272
Deposits with Commonwealth of Kentucky	487	513
Other	349	308
Total current assets	84,538	88,253
Investments at fair value, less current portion	277,109	321,560
Property and equipment, net	12,769	13,968
Deposits with Multi-State Lottery Association	3,791	3,735
Total assets	$ 378,207	$ 427,516
LIABILITIES AND EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	$ 5,605	$ 9,685
Dividends payable to the affordable housing trust fund	5,905	3,487
Notes payable, current portion	1,356	1,357
Estimated prize liability, current portion	52,621	53,926
Total current liabilities	65,487	68,455
Notes payable, less current portion	1,699	3,055
Estimated prize liability, less current portion	265,168	303,907
Total liabilities	332,354	375,417
Equity:		
Contributed capital	100	100
Retained earnings	45,753	51,999
Total equity	45,853	52,099
Total liabilities and equity	$ 378,207	$ 427,516

The accompanying notes are an integral part of the financial statements.

Kentucky Lottery Corporation
Statements of Revenue, Expenses and Changes in Retained Earnings
for the years ended June 30, 2000 and 1999
(dollars in thousands)

	2000	1999
Sales:		
Instant games	$ 297,729	$ 277,763
On-line games	285,949	305,382
Total sales	583,678	583,145
Direct costs:		
Commissions to retailers	35,256	34,378
Prize expense:		
Instant games	191,920	177,037
On-line games	150,005	163,635
Total prize expense	341,925	340,672
Ticket costs	6,314	5,642
Total direct costs	383,495	380,692
Gross profit	200,183	202,453
Operating expenses:		
Advertising and promotion	8,127	10,125
Salaries, wages and benefits	10,862	10,539
Contracted and professional services	12,598	13,538
Depreciation	3,141	2,839
Other general and administrative	5,300	5,317
Total operating expenses	40,028	42,358
Operating income	160,155	160,095
Nonoperating expenses:		
Investment income (loss)	13,392	(2,899)
Loss on single cash payments - Note 13	(4,964)	-
Interest expense	(12,883)	(12,988)
Other income	258	133
Total nonoperating expense	(4,196)	(15,754)
Net income before dividends paid	155,959	144,341
Dividends paid	162,205	159,589
Net loss	(6,246)	(15,248)
Retained earnings, beginning of year	51,999	67,247
Retained earnings, end of year	$ 45,753	$ 51,999

The accompanying notes are an integral part of the financial statements.

Kentucky Lottery Corporation
Statements of Cash Flows
for the years ended June 30, 2000 and 1999
(dollars in thousands)

	2000	1999
Cash flows from operating activities:		
Cash received from customers	$ 592,690	$ 574,398
Cash payments to suppliers for goods and services	(464,159)	(431,298)
Cash payments to employees for services	(10,862)	(10,539)
Net cash provided by operating activities	117,669	132,561
Cash flows from noncapital financing activities:		
Dividends paid	(162,205)	(159,589)
Net cash used in noncapital financing activities	(162,205)	(159,589)
Cash flows from capital and related financing activities:		
Purchases of property and equipment, net	(1,862)	(4,038)
Proceeds from disposal of equipment	-	425
Repayments of long-term debt	(1,356)	(1,357)
Interest expense	(257)	(348)
Net cash used in capital and related financing activities	(3,475)	(5,318)
Cash flows from investing activities:		
Proceeds from sale of investments	61,663	38,605
Purchase of investments	(8,562)	(13,108)
Deposits with Multi-State Lottery Association	(56)	253
Investment income	2,048	1,943
Net cash provided by investing activities	55,093	27,693
Net increase (decrease) in cash and equivalents	7,082	(4,653)
Cash and equivalents at beginning of year	22,711	27,364
Cash and equivalents at end of year	$ 29,793	$ 22,711
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	$ 160,155	$ 160,095
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation	3,141	2,839
Increase (decrease) in cash due to changes in:		
Accounts receivable, net	8,857	(8,883)
Ticket inventories	(113)	(34)
Other assets	(41)	13
Accounts payable and accrued expenses	(4,080)	2,846
Dividends payable to the affordable housing trust fund	2,418	3,487
Estimated prize liability	(52,668)	(27,802)
Total adjustments	(42,486)	(27,534)
Net cash provided by operating activities	$ 117,669	$ 132,561

Noncash investing activities:

The accretion of interest on investments held to fund grand prizes, which increased prize liability, totaled $12,626 and $12,640 for the years ended June 30, 2000 and 1999, respectively.

The accompanying notes are an integral part of the financial statements.

1. Organization:

The Kentucky Lottery Corporation (the Corporation) was created with the enactment of House Bill No. 1 in December 1988 as an independent de jure municipal corporation and political subdivision of the Commonwealth of Kentucky (the Commonwealth). The Corporation is to be managed in such a manner that enables the people of the Commonwealth to benefit from its profits and to enjoy the best possible lottery games. The operations of the Corporation are separate and distinct from other operations of the Commonwealth.

The Corporation commenced operations on April 4, 1989 with the sale of instant game tickets. Sales of on-line games began October 16, 1989. In January 1991, the Corporation joined the Multi-State Lottery Association, a group of states that combine lottery sales for on-line games.

2. Summary of Significant Accounting Policies:

a. Reporting Entity: The Corporation has adopted the provisions of Government Accounting Standards Board (GASB) Statement No. 14, "The Financial Reporting Entity," under which the financial statements include all the organizations, activities, functions and component units for which the Corporation is financially accountable. Financial accountability is defined as the appointment of a voting majority of the component unit's board, and either (1) the Corporation's ability to impose its will over the component unit, or (2) the possibility that the component unit will provide a financial benefit to or impose a financial burden on the Corporation.

The Corporation has determined that no outside agency meets the above criteria and, therefore, no other agency has been included as a component unit in the Corporation's financial statements. In addition, since the Corporation provides a financial benefit for the Commonwealth, the Corporation is part of the reporting entity of the Commonwealth and is, therefore, included in the Commonwealth's Annual Financial Report.

b. Basis of Presentation: The Corporation is accounted for as an enterprise fund. The financial statements are prepared on the accrual basis of accounting in accordance with generally accepted accounting principles. The Corporation has elected to apply all applicable GASB pronouncements as well as Financial Accounting Standards Board (FASB) pronouncements and Accounting Principles Board (APB) opinions issued on or before November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements. The Corporation has further elected not to apply FASB pronouncements issued after November 30, 1989.

2. Summary of Significant Accounting Policies, continued:

c. Revenue and Accounts Receivable Recognition: Revenue and accounts receivable for on-line games are recognized when tickets are sold to the public by contracted retailers.

Revenue and accounts receivable for instant scratch games are recognized upon activation of tickets for sale by the retailers, or 50 days from the date of issuance of the tickets to the retailers, whichever is sooner.

d. Prizes: Prize expense for instant ticket games is recorded as an estimate at the time the related revenue is recognized based on the predetermined prize structure for each game; periodically, the prize expense is adjusted to reflect amounts actually won. Prize expense for on-line games is recorded at the time the related revenue is recognized based on the known prize payout structure.

Grand prizes are awarded related to the Lotto Kentucky and Powerball on-line games. Lotto Kentucky grand prizes are paid in twenty equal annual installments or in a single lump-sum payment equal to the estimated present cash value of twenty annual payments. For Lotto Kentucky winners electing annual installments, the actual prize expense is the cost of the U.S. Treasury zero coupon bonds which the Corporation purchases to fund the annual payments. For Lotto Kentucky winners electing present cash value, the actual prize expense is the lump-sum payment equal to the cost of U.S. Treasury zero coupon bonds, priced seven days prior to the draw date, as if the Corporation was to fund twenty equal annual installments.

Powerball grand prizes are paid in twenty-five equal annual installments or in a single lump-sum payment equal to the estimated present cash value of twenty-five annual payments, except for payments made to winners under the single cash payment prize option described in Note 13. The Corporation recognizes Powerball prize expense at the time the related revenue is recognized based on the known prize payout structure. A portion of Powerball sales of the Corporation is remitted to the Multi-State Lottery Association (MUSL) to fund prize payments. MUSL purchases U.S. Government agency securities to fund prize liability to Powerball winners electing annual installments.

e. Cash and Equivalents: For financial statement purposes, the Corporation considers all highly liquid investments with an original maturity of three months or less to be cash equivalents.

f. Investments: Investments consist of U.S. Treasury zero coupon bonds and other U.S. Government agency securities carried at fair value in accordance with GASB Statement No. 31, "Accounting and Financial Reporting for Certain Investments and for External Investment Pools." Fair value of investments is based on quoted market prices.

2. Summary of Significant Accounting Policies, continued:

g. Ticket Inventories: Inventories are carried at cost (as determined by the specific identification method) and consist of pull-tab tickets located in the Corporation's warehouses or held by retailers. The cost of tickets is charged to operations upon the recognition of revenue under the procedures described above.

h. Property and Equipment: Property and equipment are carried at cost less accumulated depreciation. Depreciation is computed using the straight-line method over estimated lives of three to thirty years. When assets are retired or otherwise disposed of, the cost and related accumulated depreciation are removed from the accounts and any resulting gain or loss is reflected in operations in the period of disposal. Amortization of leasehold improvements is computed using the straight-line method over lease terms of three to five years.

i. Deposits with Multi-State Lottery Association (MUSL): Deposits are carried at cost. MUSL is an unincorporated government-benefit voluntary association created for the purpose of administering joint lottery games. MUSL currently includes 20 state lottery entities and the District of Columbia and sells three games known as Powerball, Wild Cash and Cash 4 Life. The chief executive officer of each member lottery serves on the MUSL board of directors. As a member of MUSL, the Corporation is required to contribute to various prize reserve funds maintained by MUSL. The prize reserve funds serve as a contingency reserve to protect MUSL from unforeseen prize liabilities. All funds remitted, and the related interest earnings, will be returned to the Corporation upon leaving MUSL, less any portion of unanticipated prize claims which may have been paid from the fund. The Corporation is contingently liable for a portion of the prize claims payable to the extent that such claims exceed the balance of the Grand Prize Pool, Lower-Tier Prizes Pool, Set-Aside Pool, Set Prize Reserve Pool and the Prize Reserve Trust. The collective minimum balance of these funds is $77,000,000.

j. Estimated Prize Liability: A liability for grand prize winners electing equal annual installments is recorded based on the cost of U.S. Treasury zero coupon bonds and other U.S. Government agency securities purchased to fund the liability, adjusted for the accretion of interest based upon the purchased yield and maturity date. The estimated prize liability is presented in the balance sheet net of this imputed interest. Imputed interest is amortized to interest expense over the life of the annuity utilizing the effective interest method.

2. Summary of Significant Accounting Policies, continued:

k. Dividends Payable to the Affordable Housing Trust Fund: A liability for dividends payable results from unclaimed prizes on instant and on-line games. In accordance with Kentucky Revised Statute (KRS) 154A.110(3), any unclaimed prize money from these games may be retained by the Corporation and added to the pool from which future prizes are to be awarded or used for special prize promotions, or may be appropriated by the General Assembly directly from the Corporation for any public purpose. Any unclaimed prize money in excess of $6,000,000 per fiscal year is transferred to the Affordable Housing Trust Fund, as required by KRS section 154A.110(3). Payments are made as necessary during January and July of each fiscal year, depending on the volume of unclaimed prizes.

l. Dividends Paid: Dividends paid represents a transfer of funds from the Corporation to the Commonwealth's general fund and the Affordable Housing Trust Fund. The dividends paid to the general fund, which are approved by the Board of Directors and remitted to the Commonwealth on a monthly basis, are used to benefit all Kentuckians. The dividends paid to the Affordable Housing Trust Fund are used to address the critical housing needs of extremely low income Kentuckians.

m. Use of Estimates: The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

3. Cash and Equivalents:

Cash and equivalents includes amounts held in bank accounts with book overdrafts of approximately $2,054,000 and bank balances of approximately $249,000 at June 30, 2000. Such balances are fully covered by federal depository insurance. Also included in cash and equivalents at June 30, 2000 are overnight repurchase agreements of $31,847,000 which are classified as Category 1 investments. The Corporation's investments are categorized to give an indication of the level of credit risk assumed by the Corporation at year-end. Category 1 is comprised of investments that are either insured or registered, or for which the securities are held by the Corporation's agent in the Corporation's name.

4. Investments:

The Corporation has adopted GASB Statement No. 31, "Accounting and Financial Reporting for Certain Investments and for External Investment Pools," which establishes accounting and reporting guidelines for government investments and investment pools. The adoption of this statement requires investments to be presented at fair value, resulting in additional loss, when compared to the historical cost method, of approximately $6,246,000 and $17,482,000 in 2000 and 1999, respectively.

Retained earnings at June 30 consisted of (in thousands):

	2000	1999
Retained earnings excluding unrealized gains on investments	$ 31,988	$ 31,988
Unrealized gains on investments	13,765	20,011
	$ 45,753	$ 51,999

The net increase in the fair value of investments includes all changes in fair value (including purchases and sales) that occurred during the year. The components of investment income (loss) for the years ended June 30, 2000 and 1999 follow:

	2000	1999
Investment income (loss):		
Net increase (decrease) in fair value of investments	$ 11,344	$ (4,842)
Interest income	1,964	1,795
Security lending income	84	148
Total investment income (loss)	$ 13,392	$ (2,899)

All investments held at June 30, 2000 and 1999 were in Category 1 and were held in U.S. Treasury zero coupon bonds and other U.S. Government agency securities.

Grand prize investments at June 30, 2000 and 1999 consisted of the following:

	Fair Value	
	2000	1999
Direct U.S. Treasury Investments	$ 57,290,000	$ 49,074,000
Other U.S. Government Agency Securities	253,866,000	308,601,000
	$ 311,156,000	$ 357,675,000

4. Investments, continued:

The Corporation is authorized by state statutes and investment policies approved by the board of directors to lend its investment securities. The lending is managed by the Corporation's custodial bank. All loans can be terminated on demand by either the Corporation or the borrowers, although the average term of loans is approximately one week. The custodial bank and its affiliates are prohibited from borrowing the Corporation's securities.

The agent lends the Corporation's U.S. Treasury zero coupon bonds and other U.S. Government agency securities for securities collateral of 102 percent. The securities lending contracts do not allow the Corporation to pledge or sell any collateral securities unless the borrower defaults. There are no restrictions on the amount of securities that can be lent at one time or to one borrower.

At June 30, 2000 and 1999, the Corporation had loaned investments with fair values of approximately $68,177,000 and $76,199,000, respectively, to authorized brokers for a fee. In exchange for the loaned investments, the Corporation has temporarily received direct obligations of the U.S. Treasury and securities issued by U.S. Government agencies with fair values of approximately $69,541,000 and $78,468,000 at June 30, 2000 and 1999, respectively, which are held by the Corporation's custodial bank in the Corporation's name. The Corporation's loaned investments are included in the investments reported in the financial statements rather than the securities received in the exchange.

The lending agent provides indemnification if the borrowers fail to return the underlying securities (and if the collateral is inadequate to replace the securities lent) or fail to pay income distributions on them. There were no violations of legal or contractual provisions, no borrower or lending agent default losses, and no recoveries of prior-period losses during the year. There are no income distributions owing on the securities lent. All borrower rebates, agent fees, and lender's net earnings were fully paid at year-end.

5. Accounts Receivable:

Accounts receivable at June 30 consisted of (in thousands):

	2000	1999
Accounts receivable	$ 20,003	$ 28,917
Allowance for doubtful accounts	(526)	(583)
Accounts receivable, net	$ 19,477	$ 28,334

6. Property and Equipment:

Property and equipment at June 30 consisted of (in thousands):

	2000	1999
Buildings	$ 7,129	$ 7,103
Land	423	423
Leasehold improvements	327	326
Game equipment	9,389	9,492
Data processing equipment	13,935	12,473
Automobiles, furniture and fixtures	3,232	2,956
Construction in progress	-	20
	34,435	32,793
Accumulated depreciation	(21,666)	(18,825)
Property and equipment, net	$ 12,769	$ 13,968

7. Notes Payable:

On December 18, 1996, the Corporation borrowed $6,787,000 to fund the renovation of real estate purchased during the year ended June 30, 1996 to be used as new corporate headquarters. The terms of the loan require monthly interest payments beginning December 31, 1996 with an annual interest rate of 6.66%. Principal payments began in October 1997 and are due in 60 monthly installments.

Scheduled maturities of the Corporation's notes payable are as follows (in thousands):

2001	$ 1,356
2002	1,357
2003	342
	$ 3,055

8. Estimated Prize Liability:

Estimated prize liability at June 30 consisted of (in thousands):

	2000	1999
Current:		
Grand prizes	$ 34,047	36,115
Other prizes	18,574	17,811
	$ 52,621	$ 53,926
Long-term:		
Grand prizes	$ 434,154	$ 506,669
Less imputed interest	(168,986)	(202,762)
	$ 265,168	$ 303,907

Estimated prize liability for grand prizes is based on the cost of U.S. Treasury zero coupon bonds and other U.S. Government agency securities purchased to fund the liability, adjusted for the accretion of interest based upon the purchased yield and maturity date. This adjustment of approximately $12,626,000 and $12,640,000 in 2000 and 1999, respectively, is included in interest expense. Interest expense for the years ended June 30, 2000 and 1999 consisted of (in thousands):

	2000	1999
Amortization of discount on estimated prize liability	$ 12,626	$ 12,640
Interest on notes payable	257	348
Total interest expense	$ 12,883	$ 12,988

9. Retirement Plan:

The Corporation, through its Board of Directors, has established a defined contribution retirement plan (the Plan) which covers all full-time employees. Under the terms of the Plan, the Corporation and employees each contribute 6.2% of the employee's earned annual base salary, as defined. Employees become eligible for participation and are fully vested at the date of employment for this portion of the Plan.

The Corporation also makes a contribution equal to 8% of the employee's earned annual base salary. For this portion, employees hired prior to October 1, 1993 became eligible at the date of employment and are fully vested providing participation requirements are met. Employees hired after September 30, 1993 become eligible one year after the date of employment and are fully vested after five years of service providing participation requirements are met.

For 2000 and 1999, total payroll was approximately $8,427,000 and $8,321,000, respectively. During 2000 and 1999, the Corporation's contributions were calculated using the base salary amount for full-time employees of $7,616,000 and $7,906,000, respectively, for the 6.2% employer match contribution, and $7,941,000 and $7,553,000, respectively, for the 8% additional employer contribution. Employer requirements and contributions actually made to the Plan were approximately $1,066,000 and $1,073,000 (13.7% and 14.2% of covered payroll) and employee contributions to the Plan were approximately $472,000 and $466,000 (6.20% of covered payroll) in 1999 and 1998, respectively.

10. Leases:

The Corporation has entered into operating leases for the rental of office and warehouse space under initial lease terms of one to five years.

Approximate minimum rental payments are (in thousands):

Year Ending June 30,	
2001	$ 251
2002	169
2003	64
2004	54
Thereafter	9
	$ 489

Rental expense for 2000 and 1999 was approximately $272,000 and $285,000, respectively.

11. Dividends Paid:

Dividends paid for the years ended June 30, 2000 and 1999 are summarized as follows (in thousands):

	2000	1999
General fund	$ 159,330	$ 153,800
Affordable housing trust fund	2,875	5,789
	$ 162,205	$ 159,589

Dividends paid to the general fund for the years ended June 30, 2000 and 1999 included $15,000,000 and $14,000,000, respectively, that was required by KRS 154A.130(4)(b) to be credited from the general fund to the College Access Program and the Kentucky Tuition Grants Program.

12. Insurance:

The Corporation is exposed to various risks of loss related to torts; theft of, damage to, and the destruction of assets; errors and omissions; injuries to employees; and natural disasters. The Corporation has purchased commercial insurance to cover these risks except for the asset value of certain gaming equipment located at retail establishments in which the Corporation retains risk of loss. As of June 30, 2000, there were no outstanding liabilities or unpaid claims regarding this gaming equipment. The amount of commercial coverage has not decreased nor has the amount of settlements exceeded coverage in any of the past three fiscal years. It is also the policy of the Corporation to purchase a portion of the medical insurance needed to cover its employees.

13. Internal Revenue Code Section 451(h):

As part of the Omnibus Consolidated and Emergency Supplemental Appropriations Bill for Fiscal Year 1999, Congress changed the rules under which certain lottery prizes are taxed. The changes to Section 451(h) of the Internal Revenue Code became effective on October 21, 1998. A transition rule provision exists that allows pre-October 22, 1998 winners, if there is an option, to elect a single cash payment of the remaining value of their prize within an 18-month period beginning July 1, 1999.

On May 3, 2000, the Corporation notified claimants of qualified prizes as defined in the Corporation's Rules and Regulations of the "special claim period" to exercise an option to receive the lump-sum cash value equivalency of their remaining annuitized prizes. The claim period is available through December 29, 2000 to the eligible winners. There were 189 prize winners eligible for this option as of the date of notification. As of June 30, 2000, 38 winners had exercised their option and were paid the single cash payment option. The fair market value of investments sold to meet these obligations was $24,535,000 and the estimated prize liability was reduced by $19,571,000. The Corporation recorded a loss of $4,964,000 on these single cash payments in fiscal year 2000.

As of November 29, 2000, 26 additional winners had exercised their option and were paid the single cash payment option. The fair market value of investments sold to meet these obligations was $33,092,000 and the estimated prize liability was reduced by $19,437,000. The Corporation will record a loss of $13,655,000 in fiscal year 2001 related to these transactions. The Corporation cannot determine, at this date, the ultimate financial statement impact of any additional single cash payment elections.

14. Impact of New Accounting Standards:

In June of 1999, the Governmental Accounting Standards Board issued GASB Statement No. 34, "Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments." This statement is effective for financial statements for fiscal years beginning after June 15, 2001. Management has not yet assessed the impact that the adoption of GASB No. 34 will have on the Corporation's financial statements.

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Report on Compliance and on Internal Control Over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards

To the Auditor of Public Accounts, Commonwealth of Kentucky and
the Board of Directors, Kentucky Lottery Corporation

We have audited the financial statements of the Kentucky Lottery Corporation (the Corporation) as of and for the year ended June 30, 2000, and have issued our report thereon dated August 2, 2000. We conducted our audit in accordance with auditing standards generally accepted in the United States and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Compliance:

As part of obtaining reasonable assurance about whether the Corporation's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards.*

Internal Control Over Financial Reporting:

In planning and performing our audit, we considered the Corporation's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

This report is intended solely for the information and use of the audit committee, management of the Corporation and the Auditor of Public Accounts of the Commonwealth of Kentucky and is not intended to be and should not be used by anyone other than these specified parties.

PricewaterhouseCoopers LLP

August 2, 2000